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WHAT TRIGGERS *REVLON*?

Ronald J. Gilson and *Reinier Kraakman**

INTRODUCTION

Delaware's new approach to takeover law is announced in three cases that address different aspects of management's role in the standard drama of defending against a hostile takeover. *Unocal Corp. v. Mesa Petroleum Co.*[1] scripts a main act for the drama by prescribing a duty to compare the outsider's offer with the universe of other options and, if necessary, to resist the outsider within the guidelines fixed by the proportionality test.[2] *Moran v. Household International, Inc.*[3] writes a prologue by encouraging management to plan a vigorous defense that can thwart a coercive offer without damaging the company. Finally, *Revlon Inc. v. MacAndrews & Forbes Holdings*[4] surveys the entire drama and supplies an epilogue for occasions when the best interests of shareholders will no longer permit the target to remain independent. Once the company's sale has become "inevitable," *Revlon* decrees that resistance under the aegis of *Unocal*'s proportionality test must end.[5] At this point, management's duty shifts from canvassing alternatives to a sale to determining how the sale should take place:

> The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy or effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures becomes moot. The directors' role changed from defenders of

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* Respectively, Professor of Law, Stanford University; and Professor of Law, Harvard University. Gilson's research was supported by a grant from the John M. Olin Program in Law and Economics at Stanford Law School and by the Hoover Institution, at which he was a Visiting Scholar while much of this paper was written. Kraakman's research was supported by the Harvard Law School Faculty Summer Research Program and the Harvard Program in Law and Economics, which is funded by the John M. Olin Foundation.

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1. 493 A.2d 946 (Del. 1985).
2. The proportionality test is stated as follows: "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." *Id.* at 955. *See* Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).
3. 500 A.2d 1346 (Del. 1985).
4. 506 A.2d 173 (Del. 1986).
5. *Id.* at 182.

the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[6]

As the concluding case in the *Unocal* trilogy, *Revlon* is the most difficult and far-reaching of the trio. *Revlon* ties management's obligations during a takeover attempt to a discrete event—the point at which a sale of the company becomes inevitable[7]—that is both ambiguous and commonplace, since its occurrence may be difficult to pinpoint in a hostile takeover, and yet it must arise in every friendly acquisition. Within the confines of defending against a hostile takeover, *Revlon* poses the problem of specifying precisely what action or decision finally trips the board's duty to lay down its arms and discharge "the *Revlon* obligation to conduct a sale."[8] Outside the setting of a hostile takeover, *Revlon* raises the open-ended issue of what follows when the identical action or decision occurs in the course of a friendly deal that does not respond to a hostile bid.

The continuing volume of takeover litigation makes a precise specification of which transactions or decisions trigger management's duties under *Revlon* essential and inevitable. If *Revlon* is to regulate management's actions effectively, courts and counsel must know when to instruct directors to adopt their new roles. In addition, once *Revlon*'s reach is detailed this far, defensive planners will test its limits and force the courts to articulate its reach even more precisely. From the planner's perspective, the prize of an independent—and perhaps even "unrestructured"—company will always remain within reach as long as the board's actions are governed by *Unocal*'s proportionality test. By contrast, when *Revlon* is triggered, the board may no longer be able to select the company's buyer or even dictate the form of the transaction in which it is sold. Thus, planners will continue to search for defensive transactions that can block a pending hostile bid without triggering management's *Revlon* duties.

Wherever *Revlon*'s trigger is set in the course of defending against a hostile takeover, moreover, the same trigger is likely to exist in other settings as well. Consider the problem that *Revlon* poses for the legal planner seeking to protect a friendly acquisition from possible disruption by a hostile offer. Without an effective lock-up device, *Revlon*'s application may be fatal to a friendly transaction, since it would presumably obligate the target's board to accept a higher bid by an unwanted suitor. However, the Delaware Supreme Court in *Mills Acquisition Co. v. Macmillan, Inc.*,[9] recently extended *Revlon*'s application by curtailing the planner's freedom to craft an effective lock-up. A board can only favor one bidder over another if it obtains a benefit that is reasonably related to the bid-

6. *Id.*
7. *Id.*
8. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1338 (Del. 1987).
9. 559 A.2d 1261 (Del. 1988).

ding advantage that it confers on its preferred suitor.[10]

Thus, the nature of *Revlon*'s trigger and its legal consequences are critical planning concerns over a broad range of transactions. This article anticipates *Revlon*'s further development and proposes a doctrinal framework for its application. We answer the threshold question—"What triggers *Revlon*?"—by exploring two disparate settings that span the range of circumstances in which the question matters: recapitalizations initiated by management in response to a hostile bid, and negotiated third-party or "friendly" acquisitions. In part I, a review of the case law arising from defensive recapitalizations demonstrates that transactions trigger *Revlon* only if they result in a transfer of control. In turn, analysis of *Revlon*'s application to friendly acquisitions in part II reveals the important issues of legal policy that inhere in how the control test is defined. In both settings, however, we argue that even when *Revlon* is triggered, target management retains its traditional autonomy to propose a fundamental transaction, such as a recapitalization or a third-party acquisition without initiating a formal auction as long as shareholders can freely reject management's proposal in favor of a competitive bid. Finally, part III concludes with a conjecture about how the vulnerability of shareholders to coercion—and with it, the likely content of *Revlon*'s duties—might be seen to vary systematically over a broader range of transactions.

I. *Revlon's* Trigger in the Setting of a Hostile Bid: Does the Proposed Transaction Result in a Transfer of Control?

We turn first to applying *Revlon* in the familiar setting of a defense against a hostile takeover bid. It was in this context that transactional pressure first forced the Delaware Supreme Court to announce the *Revlon* standard and subsequently pushed the courts to develop the nature of *Revlon*'s trigger. *Revlon* itself reviewed a board's decision to frustrate a hostile bidder by agreeing to a leveraged buyout by the company's managers and an affiliated investment group. Approving this transaction resulted in an inevitable "sale" of the company, in the terms used by the Delaware Supreme Court, because the transaction *was* a formal sale. For precisely this reason, however, defensive planners immediately sought to avoid *Revlon* by means of transactions, which we term "management recapitalizations," that transferred control to management without requiring public shareholders to dispose of their shares. These transactions were functionally equivalent to management buyouts. Yet, because they were not formal sales, one could argue that they merited review under *Unocal*'s proportionality test rather than under *Revlon*'s potentially more restrictive standard. The functional equivalence of management buyouts and management recapitalizations thus became a critical planning tool that forced the Delaware courts to delineate *Revlon*'s trigger more precisely.

10. *Id.* at 1288.

A. Management Recapitalizations: The Transactional Crucible for Forging Revlon's *Trigger*

The practical equivalence of management recapitalizations and management buyouts was never a secret. Their financial impact on shareholders was similar: Both transactions yielded shareholder gains of approximately the same order of magnitude.[11] Even more telling, it was always apparent that management recapitalizations were carefully crafted to shift a controlling interest to incumbent managers and their allies.[12] What was not always clear, however, was that this evasion of *Revlon*'s duties through the device of formal recharacterization would eventually fail. Indeed, the Delaware Supreme Court only recently concluded in the *Macmillan* decision, almost without discussion, that *Revlon* applies to a defensive recapitalization which transfers control to management.[13] Because the *Macmillan* court's treatment of this issue was brief, it is useful to review the history that preceded it.

Ivanhoe Partners v. Newmont Mining Corp.[14] was the first opinion by the Delaware Supreme Court to construe *Revlon*'s scope. Although *Ivanhoe* seemed to support a narrow and formalistic construction of *Revlon*'s criterion for an impending sale, its significance was clouded by idiosyncratic facts. Among other peculiarities, the transaction at issue in *Ivanhoe* was not an ordinary management recapitalization, since Newmont—the target company in the case—did not attempt to increase the equity stake of its own management. Instead, Newmont defeated a T. Boone Pickens' offer by agreeing with Consolidated Gold Fields PLC, Newmont's largest shareholder, to pay a cash dividend that permitted Gold Fields to increase its ownership to 49.7% by purchasing shares in the open market (a "street sweep"). Although this agreement did not increase management's equity stake, effective control was nonetheless transferred to management by a standstill commitment that obligated Gold Fields to limit its ownership to 49.9%, to limit its board representation to 40%, to support management's nominees for the remaining board positions, and (prior to an amendment forced by the Chancery Court) to refrain from transferring its stock to any third party who refused to be

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11. *See* Kleiman, *The Shareholder Gains from Leveraged Cash-Outs: Some Preliminary Evidence.* 1 J. APPLIED CORP. FIN. 46 (1988); P. Handa & A. Radhakrishnan, *An Empirical Investigation of Leveraged Recapitalizations: A New Takeover Defense Strategy*, Working Paper No. 480, Salomon Brothers Center for the Study of Financial Institutions, Graduate School of Business Administration, New York University (July, 1988).

12. If the amount of stock owned by management prior to the transaction was insufficient to provide management the desired level of equity given the expected post-dividend value of the stock, management control nonetheless might be assured by selling post-dividend shares to an employee stock ownership plan (ESOP) whose trustees were members of management. *See* Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772 (D. Del. 1988). Alternatively, management's stake might be increased by a pre-dividend grant of stock options that could be exchanged for post-dividend stock. *See* Robert M. Bass Group v. Evans, 552 A.2d 1227 (Del. Ch. 1988).

13. *Macmillan*, 559 A.2d at 1285.

14. 535 A.2d 1334 (Del. 1987).

bound by the commitment.[15] Because management and Gold Fields together held a majority of Newmont's outstanding stock, and because Gold Fields could neither tender to a hostile acquirer nor initiate a proxy contest on its own, the transaction was no less effective than a management buyout or recapitalization in guaranteeing management's continued control.

The supreme court quickly disposed of the claim that Newmont's recapitalization should have triggered a *Revlon* obligation to entertain Pickens' bid with an opaque comment:

> *Revlon* applies here only if it was apparent that the sale of Newmont was "inevitable." The record, however, does not support such a finding for two reasons.
>
> First, Newmont was never for sale. During the short period in which these events occurred, the Newmont Board held fast to its decision to keep the company independent. Ultimately, this goal was achieved by the standstill agreement and related defensive measures.
>
> Second, there was neither a bidding contest, nor a sale. The only bidder for Newmont was Ivanhoe. Gold Fields was not a bidder, but wished to protect its already substantial interest in the company. It did so through the street sweep. Thus, the Newmont board did not "sell" the company to Gold Fields. The latter's purchases were from private sellers . . . . Even though Newmont's declaration of the dividend facilitated the street sweep, it did not constitute a "sale" of the company by Newmont.[16]

While the court's conclusion is clear, its reasoning is not. Newmont was kept "independent" only in the sense that control was not transferred to a third party. From the perspective of the public shareholders, a shift in control did occur: control was effectively transferred to management. From this perspective, the chief distinction between the Newmont device and *Revlon*'s "sale" is that Newmont shifted control to management without allowing its public shareholders to receive a premium.[17]

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15. *Id.* at 1340. In response to a finding by the Chancery Court that the standstill agreement was a breach of the target directors' fiduciary duty, the agreement was amended to allow Gold Fields to tender into an any and all, fully financed hostile offer. Because the supreme court held that the original standstill agreement did not breach any fiduciary duty, the amendments, implemented only to cure a breach, were unnecessary. Accordingly, the analysis in the text focuses on the terms of the original standstill agreement.

16. *Id.* at 1345.

17. In Gilson & Kraakman, *supra* note 2, we offered an explanation for the cursory treatment of the *Revlon* issue in *Ivanhoe* that would not foreclose treating management recapitalizations as triggering *Revlon*. We argued that the Delaware Supreme Court saw the case as one in which Newmont management really was trying to avoid being caught between two potentially coercive offers. On the one hand, the Ivanhoe offer was for only 42% of Newmont's outstanding stock. Although the offer stated that Ivanhoe intended to acquire all remaining shares for cash at the same price as the initial offer, it also stated "that no specific second step transaction had been devised, and that there was no firm commitment to do so." *Ivanhoe*, 535 A.2d at 1139. As a result, the Court concluded that the Ivanhoe offer was a two-tier offer "fit[ting] perfectly the mold of . . . a coercive device." *Id.* at 1324.

On the other hand, Newmont management believed that Consolidated Gold Fields, Perhaps as a result of its cryptic reasoning, *Ivanhoe* did not resolve the issue of *Revlon*'s scope. The two recapitalization cases that followed it were markedly less inclined to place decisive weight on the forms of the transactions that they reviewed. In *Black & Decker Corp. v. American Standard, Inc.*,[18] American Standard opposed Black & Decker's hostile offer with a recapitalization plan that would have increased management's shareholdings from 4.8% to 23.9% and, together with an ESOP created as part of the plan, would have permitted management to control 54.5% of the company's stock.[19] In reviewing this accumulation of voting power, the *Black & Decker* court first concluded that *Revlon* is triggered when a target's board sponsors a sale of control during a control contest, regardless of the form of the transaction that transfers control.[20] After determining that American Standard's recapitalization plan would "amount to a sale" of the company, the court held that the American Standard plan triggered management's *Revlon* duties.[21]

Black & Decker was soon followed by *Robert M. Bass Group, Inc. v. Evans*,[22] in which the Delaware Chancery Court reviewed an early phase of the same control contest that eventually led to the supreme court's decision in *Macmillan*. The recapitalization plan at issue in *Bass Group* would have shifted into management's hands only 39.2% of the outstanding stock of a successor to the target company[23] that is, a voting block significantly smaller than the 54.5% that management would have controlled under the *Black & Decker* plan. Plaintiffs' claim that this shift of stock triggered *Revlon* was never decided because the Chancery Court concluded that the proposed recapitalization was disproportional to the threat posed by the hostile offer.[24] Nevertheless, the court characterized

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Newmont's largest shareholder with 26% of the outstanding stock, also posed a threat of coercion. Gold Fields held its shares subject to a 1983 standstill agreement that limited Gold Fields to a maximum holding of 33-⅓%, but that terminated if any other party acquired more than 9.9%. When Ivanhoe intentionally increased its holding to 9.95%, Gold Fields became free to "cancel the 1983 standstill agreement and acquire control of the company [presumably through market purchases], thus leaving the remaining shareholders without protection on "back end." *Id.*

As such, Newmont's defensive tactic—financing a Gold Fields street sweep with a $33 per share special dividend that gave Gold Fields 49.9% of the outstanding stock subject to a revised standstill agreement that limited Gold Fields' board membership to 40%—could be justified as a careful effort to steer a path between the explicit or implicit coercion threatened by *both* Ivanhoe and Gold Fields. *Id.* at 1343.

As it turned out, the Delaware Supreme Court distinguished *Ivanhoe* in precisely this way. *See infra* note 19.

18. 682 F. Supp. 772 (D. Del. 1988).

19. *Id.* at 782.

20. *Id.* at 780-82.

21. *Id.* at 783-84. *Black & Decker* creatively distinguished *Ivanhoe* by noting that the *Ivanhoe* court said the dividend was not a "sale" because all shareholders received it. *Id.*

22. 552 A.2d 1227 (Del. Ch. 1988).

23. *Id.* at 1235. The actual plan was somewhat more complicated than this figure suggests, since it would have split the target company into two entities yet awarded management 39.2% of the equity in only one. *Id.*

24. *Id.* at 1238.

the plan as a sale of control and broadly hinted that the plan would have been held to trigger *Revlon* if the question had been reached.[25] Thus, *Bass Group* not only supported *Black & Decker*'s holding that a management recapitalization can trigger *Revlon*, but it also suggested a critical extension of the position staked out by *Black & Decker*: The appropriate focus of the *Revlon* inquiry is on whether a recapitalization results in the "transfer of effective control," regardless of whether it transfers voting control over an absolute majority of the company's outstanding stock.[26]

The tension between the apparently narrow formalism of *Ivanhoe* and the substantive analysis of control shifts in *Bass Group*[27] was unmistakably resolved in favor of the control test by the Delaware Supreme Court's recent *Macmillan* decision. The resolution came almost casually, in the form of an explicit endorsement of the Chancery Court's earlier dicta:

> At a minimum, *Revlon* requires that there must be the most scrupulous adherence to ordinary principles of fairness in the sense that stockholder interests are enhanced, rather than diminished, in the conduct of an auction for the sale of corporate control. This is so whether the "sale" takes the form of an active auction, a management buyout, or a "restructuring" such as that which the Court of Chancery enjoined in [*Bass Group*].[28]

In short, *Macmillan* clearly holds that *Revlon* is triggered when a recapitalization imposes a change in control. While the court still speaks of *Revlon*'s trigger as a "sale," a shift in control is the only feature common to the restructuring in *Bass Group*, the choreographed auction in *Macmillan*, and the original management buyout in *Revlon*. Precisely this point was recently and emphatically made by Chancellor Allen in *Paramount Communications v. Time, Inc.*[29] in the course of elaborating on the preceding passage from *Macmillan*:

> The legally critical question this case presents then involves *when* must a board shift from its ordinary long-term profit maximizing mode to the radically altered state recognized by the *Revlon* case in which its duty, broadly stated, is to exercise its power in the good faith pursuit of immediate maximization of share value. Surely, when as in *Revlon* itself and other cases construing its command, most notably *Macmillan*, the

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25. *Id.* at 1243. In dicta, the court observed that "[s]uch a sale would arguably trigger duties under *Revlon*." *Id.* This observation is even more noteworthy because *Ivanhoe* had previously stressed the importance of a 50% voting block, in contrast to the 39.2% block in *Bass Group*, for determining when a control transaction might trigger *Revlon*. For further discussion, see *Ivanhoe*, 535 A.2d at 1343.

26. *Bass Group*, 522 A.2d at 1243.

27. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989).

28. *Id.* at 1285. *Macmillan* distinguished *Ivanhoe* on its "special facts and circumstance . . . . Specifically, Newmont's management faced two potentially coercive offers." *Id.* at n.35.

29. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), *aff'd*, Literary Partners, L.P. v. Time, Inc., (Del. Supp. 1989) (Lexis, States Library, Del. file).

board itself decides to enter a change in control transaction, it has elected to enter the *Revlon* zone. But it now appears resolved that a subjective disinclination to sell the company will not prevent that duty from arising where an extraordinary transaction including, at a minimum, a change in corporate control is involved . . . .[30]

B. *The Implications of the Control Trigger for Defensive Strategy*

In the context of responding to a hostile takeover, *Revlon* and *Macmillan* loom over the defensive planner's shoulder as a potentially serious constraint on a target's leeway to propose a recapitalization or other means of increasing its stock price without also incurring an obligation to sell the company. The critical issue for the defensive planner, then, is precisely what follows if a proposed recapitalization will—or will not—transfer control of the target company for purposes of applying *Revlon.*

When a defensive management recapitalization will result in a change of control, the issue is whether invoking *Revlon*'s auctioneering duty also limits a board's discretion under *Unocal*'s proportionality test to propose alternatives to a hostile offer. Even those who take the proportionality test seriously acknowledge that a board may appropriately offer an alternative transaction to shareholders facing an outside offer.[31] Yet, a management recapitalization clearly triggers *Revlon.* Hence the question: Does the norm of evenhandedness among competing buyers, which *Revlon* requires in other contexts, conflict with a decision to offer shareholders the alternative of a management recapitalization?

The short answer can only be: As long as shareholders remain free to choose between alternatives, the board actually facilitates an auction—and hence discharges its duty under *Revlon*—by offering shareholders an attractive alternative to an existing bid. The critical distinction is between the board's freedom to *offer* shareholders an alternative and the board's freedom to *impose* that alternative on shareholders. Any recapitalization transaction can be cast either in a form that may be implemented on management's authority alone, as in *Black & Decker* and *Bass Group,* or in a form that requires shareholder approval, whether by tender or vote.

For example, the recapitalization in *Black & Decker* could have been effected either through an issuer tender offer, (as in *AC Acquisitions Corp. v. Anderson, Clayton & Co.*[32]), or through a charter amendment requiring shareholder approval. The key difference is the presence or absence of shareholder choice. If shareholders can freely choose between a recapitalization transaction and a hostile offer, then the proposed recapitalization is a permissible alternative under both *Unocal*'s proportionality

30. *Id.* at 93,277.

31. *See* City Capital Assocs. v. Interco Inc., 551 A.2d 787, 790 (Del. Ch. 1988); Gilson & Kraakman, *supra* note 2, at 256-58.

32. 519 A.2d 103 (Del. Ch. 1986).

test and *Revlon*. However, a recapitalization plan that shareholders cannot vote to reject—even one that responds to an apparently unfair or coercive outside offer—ought to trigger the board's duty under *Revlon*, which in this context implies an effort by the board to allow shareholders to make an unconstrained choice. In other words, *Revlon* implies that a control transaction must be treated as a true alternative subject to shareholder choice, rather than as a routine defensive measure subject to balancing by the board against the coercive features of an outside offer under the proportionality test.[33]

By contrast, when a proposed recapitalization will not result in a transfer of control, the corollary of the *Revlon* control rule is that shareholders cannot demand to choose between management's proposed transaction and a hostile offer as a matter of right. Here, the issue is whether *Revlon*'s control trigger allows the board too much flexibility to defeat a hostile offer: Why should management be able to evade a shareholder choice when it plans to massively restructure the company in response to a hostile bid, regardless whether its proposal would result in a shift of voting control?

One response might be that a target company can sometimes equal or exceed the value of a hostile offer through a recapitalization. When the business plan underlying the hostile offer projects financial rather than operating gains—such as a post-acquisition strategy that contemplates increased leverage and the sale of some lines of business—target management can duplicate the strategy itself. Thus, Interco recently responded to what it perceived as a leveraged bust-up takeover offer by proposing to duplicate the core of its suitor's strategy. It planned to borrow some $2 billion, to sell assets generating approximately one-half of its gross sales, and to distribute the proceeds—with subordinated debentures and preferred stock—to its shareholders as a dividend. This dramatic restructuring, Interco claimed, would give shareholders the full profits that would otherwise have been shared with the bidder if the hostile offer had prevailed.[34]

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33. A more straightforward way of addressing when management should be able to impose recapitalizations without shareholder approval is to frame the issue in terms of a final period problem. A recapitalization that results in a change of control introduces a final period in which management no longer confronts the same incentives to safeguard shareholders interests. For a discussion of this issue, see *infra* note 68.

34. *See City Capital*, 551 A.2d at 787. As matters developed, Interco's claim was mistaken and shareholders would have been much better off with the hostile offer. *See* Sandler, *Interco Could Be a Black Mark for Wasserstein*, Wall St. J., July 10, 1989, at C1, col. 3. Note that the same approach is available to a board of directors when the proposed transaction is a management buyout motivated by a financially-based business plan. The transaction proposed by RJR Nabisco management contemplated selling the company's non-tobacco businesses and using the proceeds, together with substantial borrowings, to repurchase the public's stock, and leaving management in control of a highly leveraged tobacco company. As the RJR Nabisco board came to threaten, the company was capable of duplicating that outcome by conducting the sales and making the borrowings itself, and by paying the proceeds to shareholders as a dividend, all of which would leave the highly leveraged tobacco company in the hands of its shareholders rather than management.

Yet, the mere fact that a recapitalization plan might benefit shareholders relative to an outside offer does not distinguish Interco's plan from the proposed recapitalizations in *Black & Decker* and *Bass Group*, which now fall securely within *Revlon*'s reach. An Interco-style "non-management" recapitalization does not require *Revlon*'s protection in addition to review under *Unocal*'s proportionality test, despite the enormous change that it works on the risk and return characteristics of shareholder investments,[35] because it leaves the company's incumbent managers vulnerable to a future takeover even if they defeat the present offer. As we have argued at length elsewhere,[36] the threat of a future takeover bid is an integral aspect of meaningful proportionality review. Even if a company such as Interco can persuade a court that its proposed recapitalization is reasonable in relation to the threat posed by a hostile offer, it will probably not retain its independence indefinitely if its management's promise to create shareholder value proves empty. By contrast, a management recapitalization, like a management buyout, removes the company from the reach of the acquisitions market once and for all. Thus, unless shareholders can exercise a choice when the plan is proposed, they are unlikely to have a second chance.

II. *REVLON'S* TRIGGER IN THE SETTING OF A FRIENDLY TRANSACTION: WHAT CONSTITUTES A CHANGE IN CONTROL?

The second setting in which the planner confronts the specter of triggering *Revlon* arises in structuring a friendly transaction. Can a company agree to be acquired in what used to be the traditional manner—that is, an agreement negotiated at arm's length calling for a form of transaction, like a merger or sale of assets, that normally requires shareholder approval[37]—without shopping the transaction or otherwise conducting an auction? Not surprisingly, it was in this context that the ambiguities inherent in the simple phrase "change in control" first emerged. Precisely because both parties in a friendly transaction hope to avoid opening the field to competitive bids, there is an incentive to cooperate in casting the transaction in a form that does not trigger *Revlon.*

A. Background: The "Merger of Equals" Argument

The planners' initial response to this problem took the form of a "merger of equals." Imagine that the boards of directors of two companies, which for sake of currency we can call Time and Warner, conclude that a friendly merger is in the best interests of both corporations. The transaction contemplates that the consideration for the merger will be voting stock rather than cash. In addition, following the merger the share-

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35. *See* R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 576-77 (1986).

36. Gilson & Kraakman, *supra* note 2, at 271-73.

37. *See, e.g.*, J. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS (1975); Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

holders of Warner, the disappearing company, will receive as much as 62% of the voting shares of Time, the surviving corporation.

The planner's dilemma is the application of *Revlon*. Because the boards of the two companies believe that theirs is the best deal, neither board has any interest in shopping the transaction. However, if *Revlon* applies, both corporations will have an inchoate obligation to confirm that the implicit price reflected in the merger's exchange ratio is, in fact, the best price that can be obtained. Under such a duty, the planner's fear is that an outside buyer will emerge to offer more than the price implicit in the merger's exchange ratio, as valued by today's market, and thereby effectively terminate board authority to pursue the merger, even though both boards of directors believe in good faith that the outsider's price is inferior to the value that the negotiated transaction would ultimately yield in the future.

Efforts to protect friendly transactions from competition have taken two forms. The first and broader effort was the claim advanced by Time and Warner that *Revlon* does not apply to mergers of equals.[38] In part, this argument was essentially semantic. What triggers the shift in the board's obligation under *Revlon* is the "recognition that the company was for sale."[39] Only then does the board's duty change "from the preservation of Revlon as an entity to the maximization of the company's value at a sale for the stockholders' benefit."[40] However, a merger of equals, the argument goes, is not a "sale" but a consolidation of two companies, in which neither is a buyer nor a seller. The point of the argument is to alter the legal standard that applies to the second form of protection for friendly deals—the grant of lock-ups, leg-ups, break-up fees, privileged access to data and other means to favor a friendly bidder and discourage a competitive bidder. If *Revlon* does not apply, the standard of review presumably is the undiluted business judgment rule. If *Revlon* does apply, any effort to protect the favored transaction by deterring the making of a competitive bid is subject to *Macmillan*'s formulation of the intermediate standard: The board must show that it obtained a benefit reasonably related to the protection it provided the preferred suitor.

The argument that a merger of equals is not really a sale should recall a similar debate over the availability of pooling of interest accounting in connection with an acquisition.[41] An unfavorable accounting treatment follows when an acquisition is deemed to be a "purchase" of one company by the other and the target's price exceeds the market value of its identifiable assets: good will is created to the extent of the difference between price and market value, and the depreciable bases of tangible assets are increased to market value from their lower pre-transaction historical cost. The acquiring company's subsequent accounting earnings are therefore reduced to reflect amortization of the goodwill and the now higher depre-

38. *Id.*
39. *Revlon*, 506 A.2d at 182.
40. *Id.*
41. *See generally* R. GILSON, *supra* note 35, at 258-79.

ciation charges.

By contrast, if the transaction is deemed a "pooling" of the two companies, "groups of stockholders combine their resources, talents, and risks to form a new entity to carry on in combination the previous businesses,"[42] with the consequence that the two financial statements also may be combined without reducing reported earnings. For twenty-five years, the accounting profession has wrestled with identifying the characteristics of a true pooling transaction; at the moment Accounting Principles Board Opinion No. 16 lists some ten factors.[43] Yet, this result satisfies no one, precisely because it turns on the intrinsic meaning of the terms "pooling" and "purchase" rather than on the underlying issue of when historical costs are appropriately replaced with current costs for accounting purposes.[44]

Thus, before the Chancery Court's opinion in *Time*, the debate over *Revlon*'s application to friendly transactions threatened to reach a similar impasse over the intrinsic meaning of the term "sale." *Time*'s emphasis on "transfer of control"—on transactional substance rather than rhetoric—shifted the inquiry to its proper course. Nevertheless, as the litigants in *Time* pressed upon the Chancery Court, the potential remains for an equally convoluted debate over the meaning of "transfer of control": that is, over the choice of a test for identifying control shifts.

B. *What Constitutes a Change in Control?*

Two different approaches to defining a change in control are possible: a "voting power" rule and a "control block" rule. Either approach can be defended by plausible doctrinal and policy arguments and, on first glance, each appears to have a special advantage. Thus, the choice between these rules initially may appear critical to *Revlon*'s future development. In our view, however, an examination of the assumptions underlying the voting power and control block approaches indicates that each merely emphasizes a different aspect of a potential shift in control. Properly elaborated,

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42. Accounting Principles Board Opinion No. 16, Paragraph 28 (1970).

43. *Id.*

44. Ironically, the recent Time-Warner transaction raised not only the issue of whether a marriage of equals triggers the application of *Revlon*, but also the pooling/purchase controversy. The original merger transaction was designed to meet Accounting Principles Board Opinion (APB) No. 16's requirements for pooling of interest accounting to avoid creating the substantial amounts of goodwill that would result if the transaction had to be accounted for as a purchase. Interestingly, the substance of the transaction ultimately proved a barrier to the desired accounting treatment. Whether as a means of assuring that shareholders of both corporations would approve the merger, or as an option to deny a hostile bidder access to the 85% acquisition exemption from the Delaware anti-takeover statute (see *infra* note 54), the transaction contemplated that at either company's election the companies would exchange a substantial amount of stock in order to place votes and shares in friendly hands. Following the Paramount offer, the exchange was conducted. If the transaction then had proceeded as a stock-for-stock merger, it appears that Paragraph 46 of APB No. 16 would have prevented the transaction from being accounted for as a pooling.

the control block test, favored by Chancellor Allen in *Time*,[45] can capture the advantages of both.

1. A voting power rule: the road not taken

A voting power rule is the road not taken by Chancellor Allen in *Time*. Such a rule identifies changes in control on the basis of how much a proposed transaction dilutes the voting power of shareholders in a target company. Under this approach, a transaction that leaves target shareholders with less than 60%—or even 70% or 80%, depending on the circumstances—of their pre-existing voting power would be likely to trigger *Revlon*, just as a combination transaction triggers voting and appraisal rights under a modern corporation statute when a constituent company's shareholders retain less than 80% of the voting power in the surviving entity. [46] The rationale for the voting power test is that a large shift in a corporation's voting shares will likely be accompanied either by a change in its ownership structure that creates or further entrenches a control group, or by a material change in the identity of its management. Unlike existing corporate combination statutes,[47] however, a *Revlon* voting power test need not be based exclusively on a fractional shift in voting power; it can also weigh the consequences of such a shift for the ownership structure of the company or the continuity of its management. Thus, in determining whether control of Time would have changed for purposes of triggering *Revlon* as a result of the original Time-Warner merger agreement, a flexible voting power test would focus not only on the percentage of the surviving entity's stock held by former Time shareholders, but also on the terms of the agreement allocating half the number of board seats in the survivor to former Time directors and assuring the ultimate primacy of Time's officers in managing the combined entity.[48]

2. A control block rule

In contrast to a rule based on changes in voting power, transfers of control might also be identified by reference to a transaction's impact on a company's control structure regardless of the percentage of shares transferred. Here, the logical inquiry is whether a transaction shifts voting control to an identifiable party or group (such as management in *Black & Decker* and *Bass Group*), or leaves it diffused among disaggregated public shareholders whose particular identities may differ as a re-

45. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277-80 (Del. Ch. July 14, 1989), *aff'd*, Literary Partners, L.P. v. Time, Inc., (Del. Supp. 1989) (Lexis, States Library, Del. file).

46. *See, e.g.*, CALIF. CORP. CODE § 1201(b) (Deering Supp. 1989); DEL. CODE ANN. tit. 8, § 251(f)(3) (1974).

47. For examples of typical statutes, see *supra* note 46.

48. For a discussion of these provisions governing the future management of the surviving entity under the original Time-Warner proposal, see *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep (CCH) at 93,270.

sult of the transaction but who, because of the costs of collective action, will remain unable to exercise effective control. Chancellor Allen appears to have selected such a control block test in *Time*:

> If the appropriate inquiry is whether a change in control is contemplated, the answer must be sought in the specific circumstances surrounding the transaction. Surely under some circumstances a stock for stock merger could reflect a transfer of corporate control . . . But where, as here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger . . . [N]either corporation could be said to be acquiring the other. Control of both remained in a large, fluid, changeable and changing market.[49]

From a doctrinal perspective, such a case-by-case search for the formation of control blocks has the advantage of focusing directly on the entrenchment problem that motivates *Revlon*'s application in the first place. Although the Time-Warner merger would have diminished the likelihood of a subsequent hostile transaction by increasing the size of the surviving entity,[50] only the formation of a stable control block could entirely scuttle the prospects of target shareholders for capturing a takeover premium in the acquisitions market.[51] However, part of the price of the control block test's case-by-case focus on entrenchment is the difficulty of drawing meaningful lines. While a purely numerical voting power test may appear arbitrary, a control block test is difficult to apply to transactions that stop short of completely blocking shareholder prospects for receiving future control premiums.

Consider a continuum of possible transactions that might serve as a threshold for triggering a control block rule. At one extreme is a transaction that absolutely precludes a future premium for shareholders, such as a recapitalization that entirely eliminates the equity interest of public shareholders. At the opposite extreme is a transaction that modestly restricts shareholder access to a future premium—for example, by increasing the surviving entity's size as in Time's acquisition of Warner—but which still leaves control of the company "in a large, fluid, changeable and changing market."[52] Between these extremes is a wide range of disparate transactions that increase the difficulty of a subsequent hostile takeover without barring it completely. One illustration is the proposal in *Bass Group* to place a 39.2% voting block in management hands, which the Delaware Chancery Court and Supreme Court characterized as a control shift for *Revlon*'s purposes.[53] A second is the placement of a 15% equity stake with a white squire who supports incumbent management

49. *Id.* at 93,279.

50. *Id.* at 93,280.

51. Theodore Mirvis first argued these points forcefully to us in his comments on an earlier draft of this article. His analysis was especially prescient in light of Chancellor Allen's discussion of the change of control issue in *Time*.

52. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,280

53. *Bass Group*, 552 A.2d at 1243; *MacMillan*, 559 A.2d at 1285.

and whose holdings are large enough to bar a hostile bidder from qualifying for the 85% exemption in Delaware's business combination anti-takeover statute.[54] The obvious questions are: Where on this continuum of transactions does a change in control occur? How much entrenchment tips the balance and becomes, for purposes of *Revlon*, a change in control?

The answer cannot be that a transaction must make a subsequent acquisition premium for shareholders legally or factually *impossible*. We know from *Macmillan's* favorable reference to *Bass Group* that a transfer of only 39.2% to target management will effect a change in control.[55] The *Bass Group* transfer would have made a subsequent hostile offer both difficult and very unlikely, but not—and this is key—impossible.

A more promising approach is to ask whether management, acting without shareholder approval, grants "enough" voting power to any blockholder to allow the recipient effective power to obstruct a hostile offer. *Revlon's* focus is on management self-interest in control transactions.[56] A transfer of blocking power to a friendly third party raises precisely this specter. Once such a transfer occurs, control of the corporation for purposes of *Revlon* no longer lies, as in *Time*, with "a large, fluid, changeable and changing market."[57] At least descriptively, this is what occurred in *Bass Group*.[58]

Thus, if the *Bass Group* transaction would have triggered a control block test by transferring the effective power to block a hostile offer, how do we analyze still smaller shifts of voting blocks under a control block rule, such as those involved in Warren Buffet's new role as a white squire for Salomon Brothers, Gillette, and USAir? In these transactions, issuers have sold Berkshire Hathaway, Warren Buffet's investment vehicle, convertible stocks that pay an unusually favorable dividend rate and convert at an equally favorable rate into more than 10% of an issuer's voting stock.[59] These transactions are clearly designed to deter hostile takeovers.[60] Although Berkshire Hathaway's holdings are too small to veto

54. DEL. CODE ANN. tit. 8, § 203 (a)(2) (1974 & Supp. 1988). Under this exemption, a hostile bidder avoids the statute if it obtains 85% of the target's voting stock in the same transaction in which it becomes an "interested shareholder" by obtaining 15% of the target's stock.

55. *Macmillan*, 559 A.2d at 1270.

56. *Macmillan* describes the justification for *Revlon's* intermediate standard of review in precisely these terms: "[W]here issues of corporate control are at stake, there exists 'the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.' For that reason, an enhanced duty must be met at the threshold . . . ." *Id.* at 1287 (citation omitted).

57. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,280.

58. To be sure, a party might also accumulate enough power to prevent a takeover through private purchases or a street sweep conducted without management's assistance. Without management's aid, however, there is no entrenchment motive and management is not disabled from protecting shareholder interests.

59. *See* Sandler, *Buffet's Savior Role Lands Him Deals Other Holders Can't Get*, Wall St. J., Aug. 14, 1989, at C1, col. 3.

60. *Id.* While the terms of these sales reportedly do not restrict voting rights, they bar

hostile takeovers through voting power alone (unlike the equity blocks at issue in *Bass Group* or in *Ivanhoe*[61]), they are just large enough to deny a bidder access to the 85% acquisition exemption in Delaware's business combinations statute. Whether they are an effective deterrent, and thus meet a control block test, depends on the effectiveness of Delaware's statute.[62] Yet, if this strategy is effective, it should arguably trigger *Revlon* under a control block test for precisely the same reason that *Revlon* would have been triggered by management's block in the *Bass Group* transaction: Management has placed a veto block in the hands of a friendly supporter.[63]

3. *Reconciling the control block and voting power rules*

Stepping back from the interpretation of a control block rule, it is apparent that this case-by-case focus on entrenchment is neither less ambiguous nor necessarily more favorable to target management than a voting power rule. A broad range of transactions plausibly can shift critical voting blocks to management or a white squire. The question, then, is what is really at stake in selecting between a control block and a voting power test.

The primary advantage of a control block test is its direct focus on entrenchment—the very point of the *Revlon* standard. Properly elaborated, the control block test picks up a range of entrenching transactions, like those in *Bass Group* and small white squire placements, which might involve issuance of too little voting stock to meet the necessarily arbitrary

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Berkshire Hathaway from participating in acquisition offers and provide issuers with a right of first refusal on any resale of their stock.

61. Recall that, according to *Macmillan*, the *Ivanhoe* transaction would have shifted control absent the peculiar circumstances of conflicting coercive offers. *See supra* note 28.

62. For a discussion of Delaware's business combinations statute, see *supra* note 54 and accompanying text. The significance of the deterrence depends on the significance of the burden created by the three-year moratorium resulting from the exemption's unavailability. We have argued elsewhere that the moratorium is substantially less burdensome than may be commonly thought. *See* GILSON & KRAAKMAN, 1989 SUPPLEMENT TO GILSON'S THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 511-12 (1989). If we are correct, then it may be a mistake to expect Buffet to forego a premium hostile offer; the offer would proceed even without his participation and Berkshire Hathaway would be frozen in a minority position for three years. To be sure, the issuer could still attempt to exercise its right of first refusal if Berkshire Hathaway decided to tender, but that action would require justification under *Unocal* and, in any event, would only finance a portion of the hostile offer. This analysis suggests that Buffet not only received "deals other holders can't get," he also got something for nothing by receiving a "whitemail" premium.

63. A question then arises as to the nature of *Revlon*'s obligation in this context. For example, *Ivanhoe* suggests an active target board role, speaking of "the *Revlon* obligation to conduct a sale," 535 A.2d at 1338. Yet, *Macmillan* requires only that the target board justify its favoritism as reasonable in relation to the advantage secured, conceivably allowing a more passive role. With this approach, placing the defensive block would not trigger a requirement that the company be auctioned, but only an intermediate level of judicial review of the fairness of the terms of the block's sale. In a forthcoming article, we consider the substance of the obligations that *Revlon* imposes when it is triggered: *Revlon Refracted: Business Judgment, Conflicts of Interest, and the Decision to Sell the Company.*

percentage set by a voting power test.[64]

What may initially appear to be a secondary advantage of a control block rule is illustrated by *Time* itself. The control block rule definitively removed the aborted Time-Warner merger proposal from *Revlon*'s reach, just as it will presumably insulate many similar proposals for negotiated mergers between public companies in the future. On our analysis, however, the advantage is illusory. Selecting a control block rule was unnecessary to safeguard the authority of Time's board to propose a friendly merger. As we argue below, the *content* of Revlon's duties, properly understood, does not interfere with the established framework for negotiating a friendly merger or proposing it for shareholder approval.[65] Even more to the point, the merger proposal at issue in *Time* would not have triggered *Revlon* even under a flexible formulation of the voting power rule, since the Time-Warner agreement took great care to assure substantial continuity of management for Time's shareholders in the governance of the combined entity.[66] Thus, a voting power rule and a control block rule would have yielded an identical result in *Time*, and Chancellor Allen was never confronted with the rules' divergent concerns.

A different set of facts—one in which control of the surviving entity in a stock for stock exchange remains in the market while one company's management bows out—illuminates the competing advantage of a voting power rule: The rule is sensitive to major changes in corporate governance which arguably merit *Revlon*'s protections but which might escape the application of a control block rule. When the management of a target company relinquishes its authority by negotiating a shift of voting power, it resembles a fiduciary who concludes a relationship of trust with the beneficiaries of a trust estate, even though voting power is shifted to the dispersed shareholders of an acquiring company rather than to a single shareholder. The incentives of such a "departing" management differ dramatically from the incentives of new or continuing managers slated to operate the combined entity. For example, consider the $200 million compensation package assured to Steven Ross, the chief executive officer of Warner, by the Time-Warner merger agreement.[67] While Ross' compensation may well have been merited (and was in any case chiefly a threat to

64. So, for example, if a voting power rule set the limit at 60%, the transaction in *Bass Group* would have squeezed by. Even under an 80% limit, most white squire transactions would be protected regardless of their entrenching effect.

65. For a discussion of the control trigger for friendly transactions, see *infra* notes 69-77 and accompanying text.

66. For a discussion of whether a flexible voting power test would trigger *Revlon* due to the original Time-Warner merger agreement, see text accompanying *supra* note 48.

67. Apparently Time sought to assure Ross the value of his pre-existing compensation arrangement with Warner, which, according to a 1988 proxy statement, may have been worth up to $200 million over ten years. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,275. More generally, it should be noted that the division of authority between Time's and Warner's officers, the date of Ross' proposed retirement, and Ross' compensation arrangements seem to have been the most difficult negotiating points in the Time-Warner merger agreement. *Id.* at 93,269, 93,274-75.

Warner's, not Time's, shareholders), it is hardly inconceivable that departing managers in other transactions might be tempted to shortchange their shareholders to secure more favorable employment or termination provisions for themselves. Thus, when a departing management—or even a management that will play a subordinate role in the combined entity—proposes to transfer voting stock to an acquiring firm, it faces a powerful conflict of interest in simultaneously negotiating the terms of a merger for its shareholders and employment or settlement terms for itself.

The voting power test is sensitive to the conflict of interest faced by departing management because it is triggered, in effect, by target management *giving up* control in contrast to the control block test's focus on whether a new group *receives* control. Since the proposed Time-Warner merger neither shifted control of Time to a discernible group, nor shifted those charged with managing Time's assets, Chancellor Allen was not compelled to consider what a control block test might miss. However, if the competing advantages of the two rules are understood in this manner, then the benefits of a voting power rule can be secured with relative ease within the framework of a control block test.

The key to reconciling the rules is to recognize that the conflict of interest highlighted by a voting power test results from the fact that de facto control of a public corporation without a controlling shareholder or group resides with management. A friendly merger in which the ownership of a constituent company remains diffuse but de facto control shifts from one management team to another, is no less a control shift than a transaction that gives rise to a control block. Although the absence of a concentrated voting block lessens the hazard that shareholders may lose a future acquisition premium, it does not reduce the danger that their interests will suffer under the merger terms negotiated by their own management. And protecting shareholders against control shifts on terms favoring management is precisely *Revlon*'s charge.

Put in terms of a particular transaction, a decision by a target's board to facilitate a tender offer for the target by a public acquirer is clearly a decision to "sell" the company for purposes of *Revlon*, even if the acquirer proposes to pay for the target with its own stock and thus permits control of the target to remain "in the market." Under a flexible control block rule, such a shift in voting rights to the dispersed shareholders of the acquiring company is a de facto shift of control to the acquiring company's management. The target board's decision in this case should trigger *Revlon* not only because it may diminish the prospects of target shareholders for receiving a subsequent acquisition premium, but also because it creates an immediate conflict of interest that *Revlon*'s duties are intended to police. The public acquirer selected by the target's board may simply pay too low a price. Precisely the same conflict, however, inheres in a stock-for-stock merger that contemplates the displacement or subordination of one management team by another.[68]

These considerations suggest that the simple control block rule formulated by *Time* is more likely to mark the beginning than the end of serious inquiry into the circumstances under which control is transferred for purposes of triggering *Revlon.* If the control block rule is to avoid underinclusiveness and address the policy concerns of the voting power test, it must be applied flexibly to accommodate the realities of de facto shifts of control in transactions between widely held corporations. In addition, the control block rule will require elaboration even in the context of entrenching transactions where it originates; much work remains to be done in defining the circumstances under which management assistance in forming or transferring a voting block constitutes a transfer of control. Thus, it is predictable that the next round of the litigation game will focus on this element of *Revlon*'s application.

C. The Implications of the Control Trigger for Friendly Transactions

Time's laudable focus on a transfer of control as *Revlon*'s trigger still leaves substantial room for debate over what constitutes a transfer of control and over the application of that test to particular transactions. In our view, however, the ultimate importance of much of this prospective debate, in which we enthusiastically joined in the previous section, can be averted by returning to the issue that underlies the scope and content of *Revlon*'s duties—the role of shareholder choice.

To see how a norm of shareholder choice guides *Revlon*'s application to friendly transactions, recall our earlier discussion of *Revlon*'s application to recapitalizations.[69] Although *Revlon* applies whenever a management recapitalization would shift control over a target company, the *consequences* of applying *Revlon* turn on the availability of shareholder choice. The common characteristic of those management recapitalizations that *Revlon* barred or arguably should have barred—*i.e.*, those in *Ivan-*

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68. There is a more general way to frame this argument. The principle that explains why certain transactions require special protections or approval procedures, such as shareholder votes, is the fact of a change in control. When management negotiates or approves a transaction that reduces or eliminates its own participation in the firm, it creates what economists term a "final period problem." When two parties expect to engage in a series of transactions, both sides have an incentive to behave fairly. Any cheating by a party in one transaction will result in retaliation by the other party in the next transaction. In the last of a series of transactions, however, this incentive for fair dealing disappears. Because transactions that reduce or eliminate management's participation in the company create a final period problem, they differ from all other transactions negotiated by management, and should arguably be grouped with control transactions that require special protections or approval procedures. For a discussion of control transactions in light of the final period problem, see R. GILSON, *supra* note 35, at 575-80. The further implication that control transactions require shareholder approval is developed in American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* §§ 1.32, 6.01 (Discussion Draft No. 2, April 20, 1989). This analytical framework resolves the *Revlon* problem by reference to a principle more general than the particular circumstances of the acquisitions market.

69. For a discussion of *Revlon*'s application to recapitalizations, see *supra* notes 16-30 and accompanying text.

hoe, *Black & Decker*, and *Bass Group*—was that management imposed a change in control without the opportunity for shareholders to approve the change by voting or tendering shares. In each case, the very form of the transaction was designed to withhold from shareholders the opportunity to choose; and in at least two of these instances, *Revlon*'s application thwarted a transaction that shareholders almost certainly would have rejected. By contrast, non-management recapitalizations that do *not* contemplate a shift of control over the company escape *Revlon*'s implicit requirement of an occasion for shareholder choice—even though they, too, may ultimately fail judicial review under *Unocal*'s proportionality test if they limit shareholder choice too severely.[70]

Extending this framework to friendly transactions that conform to the traditional model of an arm's length merger suggests that little necessarily turns on whether *Revlon* applies. Shareholders always retain a choice when a merger, sale of assets, or similar transaction threatens to shift control: They can protect themselves by voting against an unfavorable merger or, more realistically, by tendering their shares to a competing bidder (such as Paramount in the Time-Warner transaction) when the merger is so unfavorable that it attracts a competitive bid. Nothing in *Revlon* requires a board to "shop" the company before agreeing to a friendly acquisition. If shareholders can vote, a merger agreement readied in the old-fashioned way—through good faith negotiations conducted at arm's length—can only expand their options. Reading *Revlon* to require something more would only jeopardize proposals that are already on the table without offering shareholders an offsetting gain. The same point may be made more sharply by observing that a merger proposal in today's market invites an auction so clearly that nothing further is required to satisfy *Revlon*'s requirements.

On this view of *Revlon*'s duties in the context of a friendly transaction, whether *Revlon* was triggered would not have mattered to the procedures by which the original Time-Warner merger was proposed. *Revlon* happens not to have been triggered under the control block test selected by Chancellor Allen, although the identical stock-for-stock merger would "plainly"[71] have resulted in a transfer of control—and, presumably, would

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70. The leading recent example is the non-management recapitalization under review in City Capital Associates v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988). In our view, Chancellor Allen correctly declined to apply *Revlon* to Interco's dramatic recapitalization plan, since that plan would not have resulted in a transfer of control. Nevertheless, Chancellor Allen also enjoined Interco—again, correctly in our view—from using a poison pill to protect the recapitalization (from the risk that shareholders would reject the recapitalization by accepting the hostile tender offer) because it was a disproportionate response under *Unocal*. An earlier case subject to the same analysis is AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986). The point, once again, is that the highly coercive "non-management" recapitalization proposed by Anderson, Clayton should not have been *automatically* barred (since it did not shift control and *Revlon* did not apply). Nevertheless, the plan was appropriately barred after review under the *Unocal* standard as disproportionate to a non-threatening outside offer.

have triggered *Revlon*—"if Warner were a private company."[71] Either way, however, the ownership structure of Time's prospective merger partner and the precise definition of a transfer of control should not interfere with the freedom of Time's board to negotiate a friendly merger.

Of course, this conclusion will not comfort the planner who seeks to protect a merger from disruption by a hostile bid *after* it is proposed. Even if management can propose a friendly transaction to shareholders without shopping the company regardless of whether *Revlon* applies, management must still face the risk of a hostile bid. In terms of the Time-Warner transaction, *Revlon*'s irrelevance to the procedure by which Time proposed its merger with Warner would have been of strictly academic interest to Time's management, so long as Time's shareholders remained free to vote against the merger in order to tender to Paramount.

Here, then, is the real way that *Revlon* matters in the context of friendly acquisitions: in determining how far management may go in attempting to restrict shareholder choice. A finding that *Revlon* applies obligates management to seek the highest bid for the company. Under *Macmillan*, this means that management cannot deploy a lockup or any other device to favor its preferred transaction partner unless its efforts are "reasonable in relation to the advantage sought to be achieved."[72] That is, these efforts must be instrumental in securing the highest price for shareholders.

By contrast, if *Revlon* does not reach a constituent corporation in a merger, *Macmillan*'s strictures do not apply. An attempt to favor the merger transaction "over" the hostile offer would resemble a non-management recapitalization for purposes of a *Revlon* analysis, and would thus be left to scrutiny under the proportionality test insofar as it served as a defensive tactic. A perfect example of this point is the "stock swap" that was intended to fend off hostile interlopers in the original merger proposal between Time and Warner.[73] If *Revlon* had been triggered by the merger agreement, the associated stock exchange agreement would have been vulnerable to a searching review under *Macmillan*. Because Chancellor Allen determined that *Revlon* was not triggered, the stock swap would have been subject to more textured review under *Unocal*'s proportionality test.[74]

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71. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,279.

72. *Macmillan*, 559 A.2d at 1288.

73. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,269-70.

74. The stock swap agreement also would have been subject to independent challenge as a form of direct interference with the shareholder vote to approve the merger. Exchanging shares before the shareholder vote is, in effect, stuffing the ballot box. Even apart from *Revlon* and *Unocal*, Delaware courts strike down blatant interference with voting rights in control contests. *See, e.g.*, Blasius Industries, Inc. v. Atlas Corp., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,965 (Del. Ch. 1988). To be sure, Chancellor Allen in *Time* rejected the argument that restructuring the transaction to eliminate a shareholder vote raised *Blasius* issues because the original vote was voluntary. Ironically, unfairly influencing the outcome of a shareholder vote is a much more serious matter than cancelling even a voluntary vote. Because a variety of important collateral consequences flow from

Similarly, in our view there should never have been any question that the *Unocal* test governed Time's attempt to defeat Paramount's hostile bid by making its own friendly tender offer for Warner. As Chancellor Allen held, Time's new offer for Warner left Time's management in place and left control of Time securely in the hands of Time's shareholders. Thus, obligations under *Revlon* or *Macmillan* were not triggered under either a voting power or a properly elaborated control block measure of a transfer of control.[75] Nevertheless, if the new offer was not a control transaction from the perspective of Time's shareholders, it remained a response to Paramount's hostile offer. For this reason, it was still required to pass muster under *Unocal*'s proportionality test. That is, the court was required to find that it was reasonable in relationship to the threat posed by Paramount's offer.[76]

In short, the significance of triggering *Revlon* in the context of a friendly transaction is largely restricted to *Macmillan*'s ban against unwarranted lockups or other pre-planned efforts to avert a competitive bid. *Revlon* matters in arm's length deals because *Macmillan* matters. Beyond this, as long as the constituent corporations in a friendly transaction do not deploy defensive tactics or lockups, an auction will take care of itself. In all likelihood, a competitive bid will emerge to challenge any friendly transaction that is so unfavorable to one of its parties that a court would be tempted to bar it after evaluating its terms.[77] The acquisition market is an exacting judge of fairness when allowed to function freely.

III. CONCLUSION: *REVLON'S* UNCHARTED REGION

In this article, we have explored a general rule that *Revlon* should apply whenever a proposed transaction would shift control over the company and examined its application in two important transactional settings. In both settings, we argue that the consequences of applying *Revlon* are not nearly as draconian as many have feared. In the standard setting of a defense against a hostile takeover, we conclude that *Revlon* allows management to offer shareholders any alternative including a management recapitalization plan. Once a bid is on the table, target company shareholders can only gain from the introduction of new offers that might

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shareholder approval of a transaction (for example, its ratification effect), rigging even a voluntary vote should be barred.

75. For further discussion of these triggers, see *supra* notes 70-74 and accompanying text.

76. A peculiarity of the Time-Warner transaction was that Paramount could not have completed its hostile offer for Time before Time completed its offer for Warner. Thus, the court was not forced to pass on the reasonableness of Time's defensive tactics but only on its continued pursuit of its plan to combine with Warner. A pointed footnote indicates that the court's analysis under *Unocal* might have been different had it been required to rule on Time's poison pill. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,284 n.22.

77. The claim is not that making a competitive bid involves no transaction costs. Rather the point is a comparative one. Judicial valuation is a notoriously inexact science. Our point is only that by the time the negotiated terms are so unfair that a court would set them aside, the gap would exceed the transaction costs of making a competitive bid.

transform a lone bid into a bidding contest. Similarly, in the friendly setting of an arm's length negotiated deal, there is no need to require management to shop the company beforehand; the announcement of a merger or similar transaction will itself attract sufficient attention from the acquisitions market to assure that a successful deal is likely to be a fair one. The only requirement that *Revlon* and *Macmillan* impose in both settings is that shareholders must retain the freedom to choose between management's preferred transaction and a competing offer. This opportunity may be an uncoerced option to tender to a hostile bidder or an opportunity to vote down management's proposal. In either case, management cannot restrict shareholder choice by erecting defensive tactics or lockups without intermediate level judicial review then substituting for shareholder choice as a check on the fairness of management's action.

Our analysis of these two contexts, however, does not exhaust the transactions to which *Revlon* and *Macmillan* apply or the content of the resulting duty. In particular, we have not considered management buyouts or recapitalizations that are undertaken on management's own initiative, outside the competitive setting of a hostile takeover attempt. Nor have we addressed negotiated transactions that fall midway between management buyouts on the one hand and arm's length deals on the other. For example, transactions in which management favors a buyer that is clearly unable to operate the company without management's cooperation, even if the terms of the acquisition make no explicit provision for transferring an equity stake to management.

In these highly (or even moderately) self-interested transactions, it is far less certain that *Revlon*'s promise of shareholder choice is adequately protected by the mere possibility that an unfair transaction might be challenged by an outside bidder. Management that initiates a self-interested transaction enjoys several critical advantages, including access to non-public information and the discretion to time its bid, that no outsider may be able to match. If management's offer is the only bid on the table, it is pointless to suggest that the possibility of unconstrained shareholder choice will adequately protect shareholder interests. For these reasons, we conjecture that there is a missing piece in *Revlon*'s puzzle that the doctrinal framework developed in this paper does not yet supply: the link between the content of target management's duty when *Revlon* applies and the degree of management self-interest in a control transaction. It was unnecessary to confront this lacuna in the two transactional settings considered here because, by hypothesis, the extreme threat to shareholder choice only arises when management transactions are *both* self-interested and proactive. The next step in our analysis of *Revlon*'s duties will be to supply the missing piece of the puzzle by constructing an expanded framework that explicitly addresses the problem of management self-interest.